

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA
CHARLOTTE DIVISION

In Re:)	Case No. 95-31870
)	Chapter 13
BILLY JOE SUMMEY,)	
)	
Debtor.)	
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ORDER

This matter comes before the Court on the Objection to Confirmation of Plan filed by Entertainment Ventures, Inc. d/b/a/ Curtis Mathes ("Curtis Mathes"). The Objection was filed on January 23, 1996 and a hearing was held on the matter in Charlotte, North Carolina on April 9, 1996. The basis of Curtis Mathes' Objection is that the Debtor's Chapter 13 plan proposes to treat Curtis Mathes as a secured creditor, while Curtis Mathes claims that its arrangement with the Debtor involves a true lease that must be either assumed or rejected by the Debtor under section 365 of the Bankruptcy Code. Based on the record before it, the Court makes the following findings of fact and conclusions of law:

FINDINGS OF FACT

1. On November 25, 1995, and prior to filing Bankruptcy, the Debtor entered into an agreement captioned, "Purchase Agreement and Disclosure Statement, ("Agreement") with Curtis Mathes. This Agreement concerned a television set and a video cassette recorder having a listed cash price of \$698.99.

2. The Agreement allowed the Debtor to take immediate possession of the T.V. and V.C.R. and called for the Debtor to make an initial payment of \$27.43 and 77 additional weekly payments of

\$17.43 for a total of \$1,359.54. However, the Agreement also provides that the Debtor can turn the items in to Curtis Mathes at any time and stop paying under the Agreement, without penalty. In addition, the Agreement provides that Curtis Mathes is responsible for all regular maintenance of the items during the 78 week contract period.

Further, the Agreement contains a provision which purports to give the Debtor an option to purchase the goods. That option states that, during the 68th week of the Agreement, the Debtor may choose to purchase the goods by either paying off the remaining amount due under the Agreement, \$174.30, or by signing a note obligating the Debtor to continue paying regular payments under the Agreement through the final week. If the Debtor chooses to exercise this option, he becomes the owner of the T.V. and V.C.R. at the end of the 78 weeks and retains possession of them. However, under the option, if the Debtor fails to exercise the option during the 68th week, he forfeits his opportunity to retain possession of the goods beyond the contract period. Otherwise, these good remain the property of Curtis Mathes, even if he completes the Agreement.

3. The Debtor filed a voluntary Chapter 13 petition on December 12, 1995.

4. On Schedule D of his petition, the Debtor listed Curtis Mathes as a partially secured creditor holding a claim of \$600.00 based on the T.V. and V.C.R. Of the \$600.00 claim, the Debtor listed \$400.00 as secured and \$200.00 as unsecured.

5. The Debtor's Chapter 13 plan proposes to pay \$375.00 per month for a ten percent payout to general unsecured creditors. Secured claims will be paid in full with interest. Because the proposed plan bifurcates its claim, Curtis Mathes objected to confirmation.

6. At the hearing, the Debtor argued that its proposed treatment of Curtis Mathes on this claim objection is appropriate because the Agreement is actually a disguised financing agreement and is subject to lien stripping. Conversely, Curtis Mathes argued that the Agreement is a true lease and must be assumed or rejected under section 365 of the Code.

7. After taking the matter under advisement, a dispute arose as to evidence that had been introduced by stipulation concerning the economic use of those goods. The Court decided that a further hearing was needed to allow counsel to address this particular issue and a second hearing on the matter was held on April 30, 1996. At the continued hearing, both the Trustee and the Debtor argued that the term of the agreement was equal to the economic life of the goods, and that therefore, under N.C.G.S. § 25-1-201(37)(a)(i), the agreement was conclusively presumed to be a security interest. Curtis Mathes argued, at the end of the 78 weeks, the goods retained additional economic life, and that the facts of the case indicate that the Agreement is a true lease.

CONCLUSIONS OF LAW

Section 365 of the Bankruptcy Code provides that a debtor must assume or reject a true lease. Further, a debtor's Chapter 13 plan

cannot modify the terms of a true lease. In the current case, the Debtor proposed a plan that modifies the original Agreement between the Debtor and Curtis Mathes. The modification is proper under section 502 of the Bankruptcy Code, if the arrangement between the Debtor and Curtis Mathes is a security Agreement. However, the modification is not proper and the plan cannot be confirmed if the Agreement is actually a true lease. Therefore, the Court must determine whether the arrangement between the Debtor and Curtis Mathes is a true lease or a security Agreement.

The question of whether an Agreement is a true lease or a security agreement, being a property right issue, is to be answered according to state law. Butner v. U.S., 440 U.S.C. 48, 995 Ct. 914 (1979). Under North Carolina's version of the Uniform Commercial Code, this determination is under General Statute section 25-1-201(37).

N.C.G.S. 25-1-201(37) contains four subsections, all of which must be considered when determining whether an agreement is a lease or a security Agreement. Subsection (a) lists four factors, the existence of any of which in a particular agreement deems the arrangement to be a security Agreement. Subsection (a) provides:

- . . . a transaction creates a security interest if:
- (i) The original term of the lease is equal to or greater than the remaining economic life of the goods, or
- (ii) The lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods, or
- (iii) The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease Agreement, or

- (iv) The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease Agreement.

N.C.G.S. § 25-1-201(37)(a)(i-iv). None of these four factors are present in the current case.

First, the original term of the lease is not equal to or greater than the remaining economic life of the goods. The term, "economic life", is not defined in the North Carolina General Statutes. However, Black's Law Dictionary defines "economic life" as "useful or profitable life of property, which may be shorter than the physical life." In this case, the original term of the lease is seventy-eight weeks. Here, if the T.V. and V.C.R. can be resold by Curtis Mathes after the seventy-eight week period, the lease term is not equal to or greater than the economic life of the goods.

At the April 30 hearing, Cindy Jenkins, an employee of Curtis Mathes presented uncontroverted evidence that Curtis Mathes will be able to sell the goods for approximately \$200 if they are surrendered by the Debtor after the lease term. In addition, paragraph eleven of the Agreement discusses a distinction in the warranties provided for new goods as opposed to used goods. Taken together, this evidence provides strong support for the assertion that Curtis Mathes is regularly able to resell goods recovered after a lease expires.

The Curtis Mathes witness also testified that the goods would be sold for \$200 regardless of whether the Debtor turned them in at the end of the seventy-eight week period or during the option

period, the sixty-eighth week. During the option period, the Debtor has the opportunity to become the owner of the goods for \$174.30. After refurbishing costs are added, this amount is nearly equal to the remaining economic life of the goods at the time, \$200, according to Ms. Jenkins' testimony. However, this fact does not provide prima facie evidence that the arrangement is a security Agreement. Subsection (b) of section 25-1-201(37) provides that:

(b) A transaction does not create a security interest merely because it provides that . . .

(v) [t]he lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed

N.C.G.S. § 25-1-201(37)(b)(v). Therefore, based on the evidence before the Court which indicates the goods would retain an economic value of approximately \$200 following the seventy-eight week lease period, the Court finds that subsection (i) of Section 25-1-201(37)(a) is not met.

Further, the second and third factors of Section 25-1-201-31(a) are, likewise, not present in this case. The Debtor can terminate the lease at any time without penalty. He is not bound in any way to renew the lease nor to become the owner of the goods. Additionally, there is no option to renew the lease for the remaining economic life of the goods at the end of the original lease term.

Finally, the fourth factor, a purchase option for nominal consideration is not present in this case. The term, "nominal," is defined in subsection (c) of § 25-1-201(37):

- (I) [a]dditional consideration is not nominal if . . .
(ii) when the option to become the owner of the goods is granted to the lessee the price is stated to be the fair market value of the goods determined at the time the option is to be performed. Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease Agreement if the option is not exercised.

N.C.G.S. § 25-1-201(37)(c)(i) (emphasis added). Under either of these tests, the consideration required of the Debtor to become the owner of the goods during the option period cannot be said to be nominal.

According to the Agreement, the Debtor can choose to become the owner of the goods during the sixty-eighth week by doing one of two things. First, the Debtor can choose to pay Curtis Mathes \$174.30 during that week. As stated earlier, according to the only evidence presented, that amount is substantially equal to the fair market value of the items at that time. As a result, the consideration is not nominal according to the first definition found in subsection (c).

Additionally, the amount required to exercise the option is not less than the cost the Debtor faces if he chooses to not exercise it, but continues to complete the original lease term of seventy-eight weeks. In fact, after taking into account the time value of money, the amount required to exercise the option is marginally higher than the Debtor's cost of continuing to perform under the Agreement. Therefore, under the second test of subsection (c), the consideration is not nominal.

The second way the Debtor can come to own the property is to sign a promissory note obligating the Debtor to complete the seventy-eight week Agreement. The Court finds that this consideration is not nominal, because the Debtor was not previously obligated in any way by the original Agreement to complete the agreement and make all of the contract payments. The Debtor has the option to terminate the Agreement at any time, without penalty. As a result, a new agreement, in the sixty-eighth week of the original contract to sign a promissory note and become personally liable for the remainder of the weekly payments, represents more than nominal consideration.

Finally, if the Debtor does not exercise his option during the sixty-eighth week, he will not become the owner of the goods, even if he chooses to complete the seventy-eight week term. Therefore, the Debtor does not have the option to become the owner of the goods for no or nominal additional consideration upon compliance with the lease Agreement.

None of the four factors, which would provide conclusive evidence that the Agreement between the Debtor and Curtis Mathes is a security agreement, is present in this case, so the conclusive presumption of Section 25-1-201(37)(a) does not apply.

Since this contract is outside the presumption, the matter becomes a question of fact: . . . "[w]hether a transaction creates a lease or security interest is determined by the facts of each case . . .". Section 25-1-201(37)(a). The Court must look to the

totality of the circumstances to determine whether this arrangement is a security agreement or is a modified true lease.

Based on all of the factors, the Court is of the opinion that the arrangement is a true lease. Several factors lead to this conclusion. First, under the Agreement, the Debtor may surrender the property at any time and terminate the arrangement without penalty. There is no obligation requiring the Debtor to continue performing under the arrangement beyond the first week. Second, the Debtor is building no equity in the property. If he chooses to terminate the Agreement without exercising the option during the sixty-eighth week, the Debtor will have absolutely no interest in the property. Finally, the Agreement provides that Curtis Mathes, not the Debtor, will be responsible for general maintenance of the goods during the term of the Agreement. Given these factors, and although this Agreement contains indicia of both a financing agreement and a lease, the Court concludes that the transaction between the Debtor and Curtis Mathes must be considered a true lease.

THEREFORE, THE FOLLOWING IS ORDERED:

The Agreement between the Debtor and Curtis Mathes is to be treated as a true lease. As a result, the Agreement must be assumed or rejected under section 365 of the Bankruptcy Code.

Further, Curtis Mathes' Objection to Confirmation of the Debtor's Chapter 13 plan is sustained.

This is the 28th day of May, 1996.



United States Bankruptcy Judge